



# WESTROCK

PARTNERS

Princeton Regional Chamber of Commerce  
January Business Council Breakfast  
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Nassau Club, 6 Mercer Street, Princeton

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Principal and a General Partner

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*"Red Flags on Your Balance Sheet:  
Understanding What Your Financial Reports Say About Your Business"*

### **Introduction:**

Curriculum Vitae of Kevin J. Conner (attached);

### **Background**

Westrock Partners is an investment-banking firm that provides corporate finance advisory and merger/acquisitions services on behalf of emerging growth companies and entrepreneurs.

Services include: (a) assisting clients in developing long-term business strategies, (b) assist in identifying and introducing clients to possible sources of capital, (either debt or equity), (c) assist in analyzing the effects of proposed transactions including participation in transaction negotiations as a consultant, (d) assist in drafting the private placement memorandum, (e) being named as a financial advisor in private placement memorandum or offering documents, (f) representation of clients' capital investments in companies either as an observer or as a member of the board of directors of portfolio companies.

In 2004, Westrock through its affiliated private equity fund successfully executed two exit strategies wherein the fund returned its investors a 3x return on their investments. (medical devices and software)

Westrock is a 2005 Corporate Sponsor of the Venture Association of New Jersey.

### **Financial Statements**

1) What is a financial statement?

*A Financial Statement is "A report providing financial statistics relative to a given part of an organization's operations or status. The two most common financial statements are the balance sheet and the income statement."<sup>1</sup>*

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<sup>1</sup> *Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor* by David L. Scott.

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- 2) What statements are typically included a full set of financial statements?
- a) Balance Sheet
  - b) Statement of Income and Retained Earnings
  - c) Statement of Changes in Stockholders' Equity
  - d) Statement of Cash Flows
  - e) Supplemental Schedules of Income, Cost of Goods Sold and Operating Expenses
- 3) Types of Financial Statements
- a. Interim Statements – 3, 6 or 9 months
  - b. Year end Statements – Fiscal Year End
  - c. Comparative Statements for period-to-period and year-to-year comparisons.
- 4) Level of Preparation
- a. Internally prepared by management
  - b. Compilation
  - c. Review
  - d. Audit

The level of preparation can be selected depending on the purpose of the financial statements. It is important to understand who the reader and intended user (s) of the financial statements are in order to determine the level of preparation.

For example, in companies that have raised private equity or maintain a significant bank relationship, management typically prepares the monthly statements internally and the quarterly and year-end statements (compilations, reviews or audits) are prepared by a CPA firm.

It is important to know private investors, and lenders will look to have a recognizable, peer-reviewed CPA firm prepare the financial statements

As investors and representatives of investors, Westrock encourages client companies to work with reputable CPA firms that truly understand the needs of the emerging growth companies and entrepreneurs. It is not just the preparation of the statements; it also includes the firm's understanding of the industry, introductions to other clients, and the management/board level feedback.

**Compilations** are basically taking the financial information from a company's books and accounts and preparing the financial statements. No detail analysis, analytical procedures nor any audit testing is performed.

**Reviews**, performed by a CPA firm, are basically taking the compiled financial information and performing analytical procedures to the accounts on a company and industry basis along with significant inquiries as to the financial condition of a company.

**Audits**, performed by a CPA firm, provides for the CPA firm to offer a professional opinion on the financial statements that the statements were audited by the firm and the statements were prepared in accordance with generally accepted accounting principles.

- 5) The mere preparation of financial statements in the form of a compilation, review or audit does not provide management with the necessary tools to help manage and grow their business unless management understands the importance of the statements and how to utilize the information.

Depending on the needs of the business, it is important to understand the following terms:

a. Liquidity

- i. Liquidity is a company's ability to convert assets into cash or cash equivalents. For example, if a company works with only cash sales then liquidity is irrelevant because each sale transaction automatically creates cash. However, in a business where there are accounts receivable, liquidity is a major concern and daily challenge for the entrepreneur.

One of the primary concerns of an entrepreneur is over the course of time; how many days (**weeks/months**) does the company take to collect its account receivable?

- ii. Accounts Receivable Ratios. These ratios help determine the collectability and adequacy of accounts receivable. Some of the more common accounts receivable ratios include:

1. Accounts Receivable Turnover—indicates the quality of the accounts receivable, and also provides an indication of how successfully the client is collecting its outstanding accounts receivable.
2. Days Sales in Accounts Receivable—estimates the average collection period for credit sales.

b) Cash Flow

- i. Cash flow is the lifeline of any business enterprise. Management, investors and creditors all benchmark a company's ability to create cash and its ability to maintain a positive cash flow.
- ii. A company's ability to create a positive cash flow is a serious challenge that entrepreneurs deal with everyday.
- iii. The two primary reasons that businesses fail are because of poor management and the lack of capital.

- iv. The main focus of a management team is building a highly efficient company that creates cash flow and in turn creates value for shareholders.
- v. Some of the cash flow benchmarks/ratios include:
  - a) Cash flows provided by operations – this provides for the company’s ability to create positive (or negative) cash flows from operations. This indicates, over time, the company’s operational efficiencies. This ties liquidity and cash flow together and is a strong indicator of management’s effectiveness.
  - b) Earnings before interest, depreciation and taxes (EBITDA) – indicates the quality of earnings.
  - c) Unleveraged free cash flow (ULFCF) – indicated the company’s ability to cash flow after debt service. This provides for an overall indicator of a company’s ability to meet its short term and long-term obligations and whether the company needs to incur long-term obligations in order to meet its short-term obligations.
  - d) Banks and other lending institutions benchmark unleveraged free cash flow because they do not favor lending a company money on a short-term basis for working capital purposes when the company does not have the ability to meet this short-term obligation. The banks normally will further benchmark this with a 30-day pay down period each year wherein a company is required to pay the working capital loan to zero.

## 6) Creative Accounting Practices with Financial Reporting

### a. Creative Accounting Practices

*Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and any steps taken toward earnings management or income smoothing.<sup>2</sup>*

## 7) Red Flags on Your Balance Sheet

- a) Cash (book overdrafts),
- b) Prepaid expenses,
- c) Allowance for doubtful accounts,
- d) Loans to shareholders,
- e) Investments in subsidiaries,
- f) Current liabilities exceed current assets (negative current ratio),

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<sup>2</sup> The Financial Numbers Game (2002), Mulford & Comiskey

- g) Accrued interest on loans from shareholders (debt vs. equity),
- h) Inadequate capital structure,
- i) Accumulated deficits,
- j) Corporate governance issues,
- k) Inadequate disclosures; related party transactions.

#### 8) Off Balance Sheet Issues

The undisclosed or unconsolidated "related entities" have become a major issue. The formal term is "*Consolidation of Variable Interest Entities*".

The accounting standards board has issued guidance on; a) consolidation based on **majority voting control**<sup>3</sup>, and b) consolidation based on **majority financial control**.<sup>4</sup>

FIN 46 defines an entity as "any legal structure used to conduct activities or to hold assets". This would include partnerships, limited liability companies, corporations, and trusts.

#### **Common Practice Issue:**

If an individual owns real estate in their own name and leases the property to a related party operating company (very common in private companies), FIN 46 does not apply. However, if an individual is a guarantor of the debt of an entity that owns the real estate, this triggers a de facto related party relationship and the operating company would need to consolidate the entity that owns the real estate if it is its primary beneficiary. This related party relationship may warrant consolidation of both entities for financial reporting purposes.

#### 9) Other Issues

It is extremely important to understand there are related entities that may require consolidation for the financial statements to be prepared in accordance with generally accepted accounting principles. A forward looking conversation with the user of the financial statements i.e. investors, banking and credit institutions may save a company considerable expense in order to address this issue.

#### **Common Practice Issue:**

In 2004, one of Westrock's clients was a potential acquirer of a company that had this problem with several related entities that either held assets for lease to the operating company and/or other related party issues. The company would not agree to have an audit of the financial statements by a recognized CPA firm. They would not consider disclosing the related party transactions nor would they consolidate all of the entities, therefore, as the potential buyer, we advised our client to pass on the acquisition.

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<sup>3</sup> Financial Accounting Standards Board (FASB #94)

<sup>4</sup> Financial Accounting Standards Board (FIN #46)